TESORO

**Comments to the House Ways and Means Committee Energy Tax Reform Working Group**
***Tesoro Corporation***
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## The United States Refining Industry

The US is the largest, most sophisticated producer of refined petroleum products in the world. The refining industry not only provides fuels and raw materials that are a vital input to almost every sector of the American economy, but as one of the country's largest manufacturing sectors, directly employs approximately 108,000 workers.

In 2012, there were 134 refineries in operation in the US. Operating refineries had a capacity of 16,744,291 barrels-per-calendar-day, with an annual utilization rate of about 89 percent. No new refinery with significant operating capacity has been constructed since the mid-1970s. That year, 1977, there were 282 operable refineries with a capacity of 16,398,000 barrels-per-calendar-day. As the number of refineries has declined, the operating capacity of existing refineries has been enhanced to keep up with demand.

## Tesoro

Tesoro Corporation ("Tesoro"), founded in 1968, is based in San Antonio, Texas, and is one of the largest independent petroleum refiners and marketers in the United States. Tesoro's subsidiaries, operating through two business segments, primarily manufacture and sell transportation fuels.

- The refining operating segment, which operates seven refineries in the western US, refines crude oil and other feedstocks into transportation fuels, such as gasoline and gasoline blendstocks, jet fuel, and diesel fuel, as well as other products. In 2012, Tesoro agreed to acquire BP's Southern California refining, logistical, and marketing assets, pending approval by the Federal Trade Commission and the California Attorney General.

- The retail operating segment sells transportation fuels and convenience products in eighteen states through a network of 1,402 retail stations, primarily under the Tesoro, Shell, and USA Gasoline brands.

## Issues of Importance

### Last-in, First-out

Last-in, First Out (LIFO) accounting assumes companies sell their newest inventory first, allowing them to more properly match current costs of inventory with current sales prices. When goods are sold, profits are calculated as the sale price minus the inventory cost of the newest inventory purchased. LIFO is not a "tax loophole." Rather, it is an accounting method used by a variety of businesses since the 1930s.

Changing to a first-in, first-out (FIFO) accounting system, where it is assumed the oldest inventory items are sold first, does not provide protection from rising inventory costs and would increase a company's tax liability in times of inflation.

For fuel manufacturers, repealing LIFO would amount to a retroactive tax hike totaling nearly $25 billion in accelerated tax liability. Refiners and petrochemical manufacturers are the first purchasers of crude oil and natural gas off the world market and are therefore particularly sensitive to crude oil price inflation and volatility. The nature of the market creates extreme volatility in the price of crude oil. Between December 2007 and July 2008, data shows that the price of crude oil increased by 46%. Only five months later, in December 2008, prices had decreased by 69%. Three years later, in December 2011, prices were 140% higher.

Repeal could be devastating for taxpayers whose LIFO reserve, or the difference between the LIFO profit calculation and the FIFO profit calculation, exceed retained earnings. This is especially true for Tesoro. In 2011, the company's LIFO reserve to net income ratio was more than 3 to 1. Repealing LIFO would force companies to either divert their operating cash flows away from investment or borrow funds to pay the recapture tax. This could devastate US businesses and jobs, and increase transportation fuel prices for consumers.

## Publically Traded Partnerships

A business structured as a Publically Traded Partnership (PTP) is not taxed at the entity level; however ownership interests are publically traded. Income is taxed only at the shareholder level, avoiding double taxation at both the corporate and shareholder level. PTPs which operate in the energy industry are commonly known as Master Limited Partnerships (MLPs). MLPs have been in existence since 1981.

In 1987, Congress enacted section 7704 of the Internal Revenue Code (IRC), limiting pass-through tax treatment for PTPs receiving at least 90 percent of their gross income from a narrow range of business activities, primarily those related to natural resources, or passive income sources such as interest, real property rents, and dividends. Natural resources include oil and natural gas (and products thereof), as well as fertilizer, geothermal energy and timber, industrial source carbon dioxide, alcohol fuel, biodiesel fuel, alternative fuels, mined natural resources, and other things; and refining is included on the list of permissible activities.

MLPs have become the primary builders of midstream energy infrastructure for the US economy and have invested $113 billion in private capital in US energy infrastructure since 2007. 300,000 miles of pipelines that form the backbone of US energy infrastructure, linking energy producing regions with end use consumers and manufacturers, are owned by MLPs. This level of investment in domestic energy infrastructure might not have occurred without MLPs.

Reform of the MLP construct could challenge the ability of energy companies to use this tax structure. Midstream energy assets are capital intensive, but typically earn low returns on capital. MLPs reduce the cost of delivering energy to customers, as the combination of investor demand for income paying securities and pass-through status provides MLPs with a low cost of capital.

**Section 199 – Domestic Manufacturing Credit**

In August 2001, the World Trade Organization ruled that the US Tax Code voided the Agreement on Subsidies and Countervailing Measures by excluding extraterritorial income. Congress in 2004 repealed the exclusion and enacted section 199 of the IRC, which allows manufactures to deduct a percentage of their "qualified production activities income."

Section 199 provides tax relief for *all* qualified domestic manufacturers to help stimulate manufacturing activity in the US. *Every* domestic manufacturing business is eligible for a deduction equal to 9 percent of the income earned from qualified manufacturing, producing, growing, or extracting activities. However, oil- and gas-related activities are limited to only a 6 percent deduction.

The deduction should be preserved and is needed to keep American fuel manufacturers competitive in an increasingly competitive global market place. Section 199 encourages manufacturers to continue domestic investment and employment. Disallowing the deduction would threaten about 1.8 million oil and gas worker jobs and nearly 4 million jobs producing goods and services used by the oil and gas industry. Repealing the deduction would also increase the price of gasoline and other finished petroleum products for American consumers.

Rather than eliminating the 6 percent deduction for oil- and gas-related activities, Congress should consider raising the deduction to 9 percent for domestic independent refiners. Unlike fully integrated oil and gas companies, independent refiners do not have upstream operations. These upstream activities, which include exploration and production, make integrated companies more profitable.

**Section 198 —Environmental Remediation Incentive (Brownfields)**

Section 198 allows refining companies that purchase existing refineries that are designated as contaminated sites to take tax deductions for environmental remediation costs. The incentive allows a taxpayer to deduct the costs of environmental cleanup in the year the costs were incurred, rather than capitalizing the costs to non-depreciable land, providing a financial benefit that stimulates environmental cleanup and revitalization. This deduction expired in 2011.

For Tesoro, Section 198 applied to every refinery purchased for which the company then assumed the environmental liabilities. Without Section 198, Tesoro (and other refiners) are penalized for having assumed another company's environmental liabilities. Because companies doing the cleanup face an increased cost burden from remediation expenses, companies could be discouraged from engaging in such activities without the tax incentive.

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